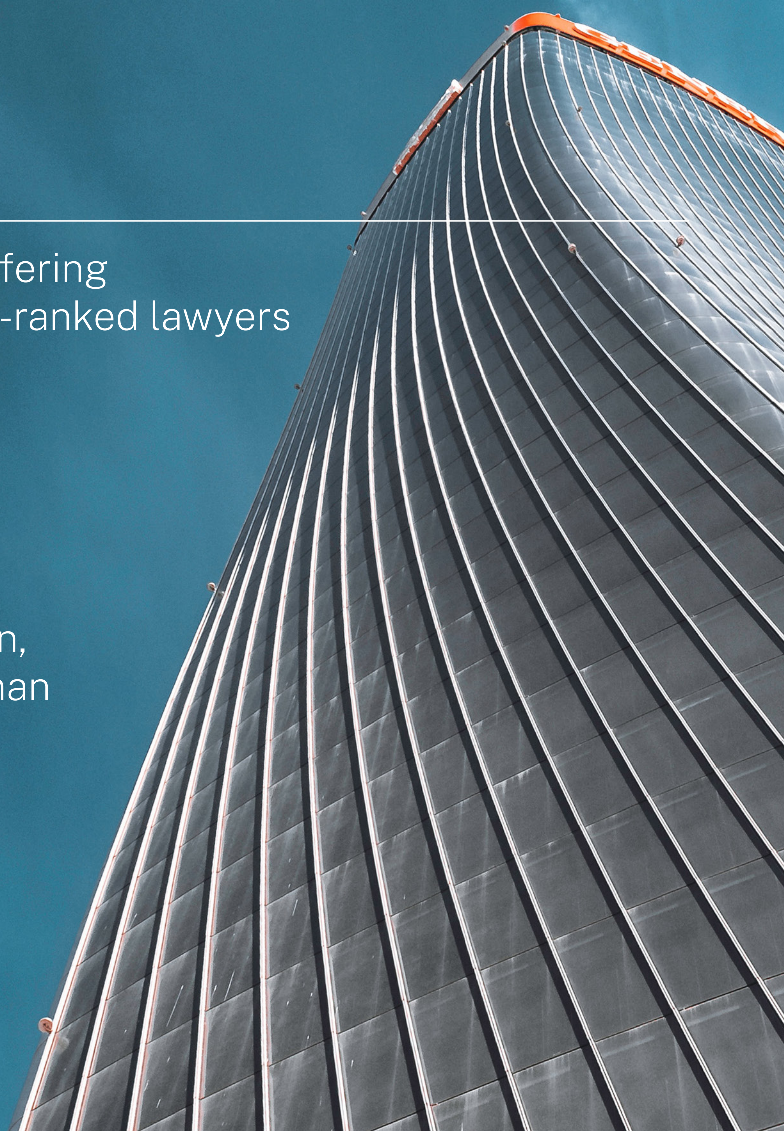
Chambers
AND PARTNERS

CHAMBERS GLOBAL PRACTICE GUIDES

Alternative Funds 2023

Definitive global law guides offering comparative analysis from top-ranked lawyers



USA: Law & Practice

Henry Bregstein, Wendy Cohen, Allison Yacker and Lance Zinman
Katten

USA

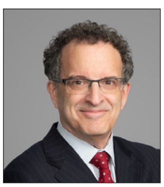
Law and Practice

Contributed by:
Henry Bregstein, Wendy Cohen, Allison Yacker and Lance Zinman
Katten

Contents

Katten is a world leader in advising hedge, private equity and other alternative funds and asset managers, proprietary trading firms and other market participants that deploy trading strategies to reshape markets and change investor expectations. Serving at the forefront of this industry since its inception, the firm guides clients through the full scope of issues vital to their business, including regulation and compliance, litigation and enforcement, tax, corporate and transactional, trading limits, technology and cybersecurity, and employment, among others. The team continues to be a comprehensive resource for some of the world's largest and most successful investment management firms and institutional investors in alternative investments, helping them to address myriad complex issues against the backdrop of rapidly changing financial markets grappling with the aftermath of a worldwide pandemic, as well as the impact of inflation and global economic challenges.

Authors



Henry Bregstein is chair of Katten's alternative products practice. He combines an innovative legal mind-set with business practicality, advising varied market participants on business structuring, financial product engineering and regulatory compliance. He is recognised as a leading adviser to investment managers and funds of all kinds, as well as to investors and distributors of alternative investments. Henry provides guidance on fund formation and regulatory compliance to all types of alternative investment funds, including hedge, private equity, insurance dedicated and hybrid funds.

Wendy Cohen is managing partner of Katten's NY office and co-chair of the investment management and funds group. She understands the business realities and challenges of the competitive world of asset management, in which she has practised for over three decades. She is a "go-to" legal resource offering pragmatic advice to asset managers of both large and established hedge funds, as well as innovative players with alternative strategies, who turn to her to navigate the complex minefield of regulation that governs private investment funds. Clients rely on Wendy to suggest practical strategies that are commercial, while minimising the risk of regulatory violations.

Allison Yacker is co-chair of the investment management and funds practice and represents a wide variety of sponsors (both hedge and private equity) and investors in transactional, fund formation, regulatory and corporate matters. Her significant experience in representing institutional and emerging asset managers, as well as all manner of buy-side investors, gives her a unique insight into market trends as they develop. This enables Allison to provide customised and solution-oriented counsel to her sell-side and buy-side clients in an efficient and timely manner.

Lance Zinman is global chair of Katten's financial markets and funds practice. He provides comprehensive legal services to asset managers, proprietary trading firms and other participants in the financial markets in need of a single adviser to assist with all aspects of their business. His unique skill set combines a deep understanding of corporate, regulatory, intellectual property and tax law with broad knowledge of the securities and derivatives markets. Using his extensive experience in these interconnected areas, he finds creative solutions to legal challenges while also providing practical, common-sense counsel.

Katten

525 West Monroe Street
Chicago
IL 60661
USA

Tel: +1 312 902 5200
Fax: +1 312 902 1061
Email: jessica.walter@katten.com
Web: www.katten.com

Katten

1. General

1.1 General Overview of Jurisdiction

Given the breadth and depth of its economy and financial markets, the liquidity of its securities, commodity futures, swaps and options exchanges, and its robust legal and regulatory framework, the United States is understandably a predominant jurisdiction for alternative funds and their managers and investors. At the end of 2022, the US GDP amounted to USD26.138 trillion; there were over 55,000 alternative funds with more than 5,473 managers and USD21.1 trillion in assets under management (which notably does not take into consideration the significant leverage utilised by many alternative funds).

2. Funds

2.1 Types of Alternative Funds

Alternative funds established in the United States, whether as standalone entities or as part of master-feeder or other fund complexes, range from liquid open-end funds to closed-end self-liquidating funds (with hybrid funds in between), and finally even to permanent capital funds.

Open-End Funds/Strategies

Strategies commonly pursued by open-end funds include quantitative and algorithmic trading, credit, global macro, long/short, commodities, trade finance, currencies, ESG, and cryptocurrencies and other digital assets.

Closed-End Funds/Strategies

Strategies pursued by closed-end funds are generally more illiquid in nature and include real estate (including development), direct lending, venture capital, infrastructure, insurance-linked securities, royalties, litigation finance, life settlements, impact investing, ESG, precious metals and mining, film financing, aircraft leasing and cannabis.

2.2 Fund Structures

The most common fund structures utilised in the United States include standalone funds, master feeder and parallel structures, and so-called "mini-master" funds; the latter two structures involve related investment vehicles established in non-US jurisdictions for tax and regulatory reasons.

Entity Type

US funds are typically structured as limited partnerships or limited liability companies (LLCs), which offer limited liability to their limited partners or members, as well as favourable flow-through tax treatment.

State Formation

Given that there is no federal corporate law in the United States, funds must be formed under the laws of one of the states; US funds are most commonly formed under the laws of the State of Delaware because of the flexibility of its statutes and its comprehensive body of jurisprudence in corporate, partnership and related areas affecting alternative funds.

Specialised Structures

Permutations of these core structures are often used to provide investors with access to certain strategies in a tax-efficient manner. For example, insurance dedicated funds (formed as limited partnerships or LLCs) are an example of a specialised type of fund that is utilised to support privately placed life insurance and annuities, which can provide tax deferral or elimination for taxable US investors.

2.3 Regulatory Regime for Funds

Alternative funds are typically structured to be exempt from registration requirements under various US federal and state laws. Several of the primary relevant US federal laws are described below.

Securities Act of 1933

The Securities Act regulates the offer and sale of "securities" by their issuers, including issuers that are alternative funds. Pursuant to the Securities Act, all securities offered in the United States must either be:

- registered with the US Securities and Exchange Commission (SEC); or
- offered and sold in compliance with an applicable exemption from registration.

Safe-harbour exemptions

Generally, securities issued by alternative funds are offered in the United States pursuant to a "safe harbour" exemption from registration under Rule 506 of "Regulation D" under the Securities Act. Rules 506(b) and 506(c) of Regulation D allow issuers to privately place an unlimited number of securities, subject to certain restrictions and requirements. Rule 506(b) is the older and more commonly utilised of the two safe harbours and permits the issuer to sell its securities to an unlimited number of "accredited investors", as defined in Regulation D, and up to 35 non-accredited investors, subject to certain enhanced disclosure requirements; provided that the securities are privately placed and are not offered by means of "general solicitation" (such as television and print advertisements and unsolicited "cold calling"). (Accredited investor status, although primarily determined by financial metrics, has recently been expanded by the SEC to extend to "knowledgeable employees" of the fund's investment manager and certain limited professional categories, and pertains to natural persons and entities.) In contrast, securities sold pursuant to a Rule 506(c) offering must exclusively be sold to accredited investors, and general solicitation is permitted. Rule 506(c) also imposes certain heightened obligations on the issuer to confirm the "accredited investor" status of investors, and remains relatively little utilised by alternative funds.

Investment Company Act of 1940

The Investment Company Act defines and regulates "investment companies". While the definition of "investment company" is complex and includes a number of qualifications, broadly speaking, it encompasses entities that are engaged in the business of "investing, reinvesting, owning, holding or trading in securities", or that hold themselves out as doing such. Although most alternative funds that focus primarily or exclusively on investing in securities fit within this definition, such funds are commonly structured to fall into one of the two following exclusions under the Investment Company Act:

- Section 3(c)(1) excludes funds that do not make or propose to make a public offering of their securities and have fewer than 100 beneficial owners (or 250 if the fund is a qualifying venture capital fund) of its outstanding securities (other than short-term paper). The beneficial owner limitation is subject to detailed counting and "look-through" rules.
- Section 3(c)(7) similarly excludes funds that do not make or propose to make a public offering of their securities; however, instead of a numerical limit on beneficial owners, to be eligible for the exclusion under Section 3(c)(7), the outstanding securities of the fund must be owned exclusively by investors who qualify as "qualified purchasers" under the Investment Company Act (and "knowledgeable employ-

ees" of the fund's investment manager). The term "qualified purchaser" is defined in Section 2(a)(51)(A) of the Investment Company Act and most notably includes individuals with qualifying investment portfolios of at least USD5 million and entities with qualifying investment portfolios of at least USD25 million.

Investment Advisers Act of 1940 ("Advisers Act")

See **3.3 Regulatory Regime for Managers**.

Commodity Exchange Act (CEA)

The CEA is the primary federal statute regulating the commodity futures and derivatives markets and is therefore relevant to the large and important segment of the US alternative funds sector that engages in quantitative and algorithmic trading, as well as other funds that trade in those markets. The associated primary regulator is the Commodity Futures Trading Commission (CFTC).

Securities Exchange Act of 1934 ("Exchange Act")

There are several aspects of the Exchange Act that may be relevant to an alternative fund's operations:

- Broker-dealer registration – a fund itself would not qualify as a broker-dealer, as it is an issuer that deals only in its own securities (ie, the fund interests) and neither effects transactions for the accounts of others nor is engaged in the business of buying and selling securities for its account. Certain associated persons of a fund that market interests in the fund can rely on the nonexclusive "safe harbour" of SEC Rule 3a4-1 under the Exchange Act, which provides that broker-dealer registration is not required for such persons provided (among other things) that they are not subject to certain "bad actor" disqualifications, are not compensated on a transaction-specific or commission basis and are not otherwise associated persons of a registered broker-dealer.
- Section 13 Reporting – See **3.3 Regulatory Regime for Managers**.
- Public company reporting – once a company has 2,000 or more investors on record, that company becomes subject to public company reporting requirements. Therefore, alternative funds will typically limit their investors to a maximum of 1,999.

ERISA

If 25% or more of the interests in a fund are owned by certain benefit plan investors, including IRAs, 401(k) plans and other plans covered by the Employee Retirement Income Security Act (ERISA), all assets of the fund will be deemed to be attributable to benefit plan investors and the fund will be subject to fiduciary responsibility provisions under ERISA and certain prohibited transaction provisions under both ERISA and the Internal Revenue Code.

State Regulation

Alternative funds must ensure compliance with state securities laws (so-called "blue-sky laws") and related regulations. In many cases, funds' compliance with federal laws can pre-empt, or at least limit the scope of, applicable state laws.

No Investment Limitations

While there are no generally applicable limitations with respect to permissible fund investments, there are specific investor-based qualifications that alternative funds must meet in order to invest in certain products. In addition, alternative funds must meet certain criteria in order to purchase certain types of products and engage in certain types of transactions. For example, a fund must be a so-called "qualified institutional buyer" (QIB) in order to purchase restricted securities transacted under SEC Rule 144A and must be an "eligible contract participant" under the CEA to engage in over-the-counter derivative transactions.

Regulatory Approval Process

As stated above, alternative funds typically offer their securities in compliance with exemptions or exclusions from registration requirements under US securities and commodities laws; therefore no prior approval or review is required for an alternative fund to issue securities. However, alternative funds relying on Regulation D are required to make a regulatory filing with the SEC on Form D within 15 days of the first sale of fund interests and, in many cases, corresponding "notice filings" under state blue-sky laws where the fund has sold its securities.

2.4 Disclosure/Reporting Requirements

With the SEC

If a manager is registered as an investment adviser with the SEC, the manager must file certain periodic reports with the SEC with respect to the funds it manages or advises.

- All registered advisers must file Form ADV, which contains private fund-specific disclosures, including, but not limited to, fund type (eg, hedge, private equity), assets under management, aggregate investor totals and composition by investor type and data on service providers used by the fund.
- Certain registered advisers must complete Form PF filings, which contain more detailed information on the funds they manage or advise than is disclosed in Form ADV. Form PF is required to be filed on an annual or a quarterly basis, with more frequent filings required for larger private fund advisers.

With the CFTC/NFA

Some funds and managers are also required to prepare and distribute certain reports pursuant to the CEA and the rules promulgated by the CFTC and the National Futures Association (NFA).

- Generally, managers that are registered as commodity pool operators (CPOs) must file commodity pool-specific annual reports with the NFA and must also distribute these reports to pool participants (ie, fund investors). These reports contain information on the pool, including financial details and aggregate information on fund investors. CPOs must also prepare and distribute certain pool-specific periodic investor reports (which are not required by the NFA).
- CPOs also typically need to file pool quarterly reports (PQRs), on Form CPO-PQR, with the NFA or the CFTC, reporting certain fund-specific details.
- Commodity trading advisers (CTAs) that direct commodity pool assets typically need to file quarterly and annual reports, on Form CTA-PR, which includes general information with respect to such pool assets.
- Some commodity pools are subject to significantly less extensive disclosure requirements than those outlined above, including:
  - (a) pools that qualify for relief under CFTC Rule 4.7; and
  - (b) funds that engage in trading of commodity interests only "incidentally" to their securities trading activities and that commit less than 10% of their assets to commodity interest margin and option premium, qualify for relief under CFTC Rule 4.12(b).

Other

See **2.3 Regulatory Regime for Funds** under the heading "Regulatory Approval Process" with respect to securities-level filings, and **3.3 Regulatory Regime for Managers** with respect to manager-level filings.

2.5 Tax Regime for Funds

No Entity-Level Income Tax on Flow-Through Funds

The United States generally does not impose any entity-level income tax (other than withholding tax on certain types of income or gain allocable to non-US investors) on unincorporated domestic funds such as limited partnerships and LLCs. Instead, the beneficial owners of such funds report and pay the applicable federal income taxes on their allocable share of the fund's taxable income and gain as reported to them annually by the fund on an Internal Revenue Service Schedule K-1. However, in certain circumstances, a fund could be treated as a "publicly traded partnership" and taxed as a corporation for federal income tax purposes unless the fund satisfies an annual 90% "qualifying income" test.

Corporate Income Tax

In the usual circumstance where a US fund is treated as a corporation, such fund is subject to US federal income tax and may be subject to state income tax.

2.6 Loan Origination

No Limitations

Alternative funds are permitted to originate loans.

State Licensing

An analysis of all relevant factors must be undertaken to determine whether a state commercial lending licence is needed with respect to a transaction. This typically includes an analysis of:

- the location of the borrower;
- the location of the lender;
- the location of the collateral;
- the place from which the loan proceeds will be originated;
- policy considerations; and
- applicable state law.

If licensing is required, information concerning the fund, its affiliates, its owners and its business plan is often necessary.

State Usury Laws

Certain states impose limitations on the permissible amount of interest that may be charged on a commercial loan. Relevant determining factors include the type of borrower and size of the loan.

Tax Considerations

As originating loans may be considered to be engaging in a US trade or business, US federal and state tax considerations with respect to originating loans are complex.

2.7 Non-traditional Assets

Alternative funds can invest for their own accounts in cryptocurrencies as well as other non-traditional assets, generally without implicating special rules. However, by way of example, if a fund is managed by a CFTC registrant, express disclosure requirements are imposed by the NFA that are different than if the virtual currencies are accessed in the spot market or as futures. Furthermore, it is worth noting that certain crypto-assets are deemed to be securities under US securities laws and that a fund's activities need to be limited strictly to investment and trading to avoid falling within the ambit of, for example, state custody or money transmission laws.

2.8 Use of Subsidiaries for Investment Purposes

The use of subsidiaries for investment purposes is relevant in the following contexts:

- Depending on the investment strategy, special purpose vehicles and other subsidiary entities may be used if it is prudent to ring-fence assets in light of liability or bankruptcy concerns.
- Subsidiaries, such as so-called master funds or trading subsidiaries, may serve as collective investment vehicles for different types of investors. Such subsidiaries may be formed as, or elect to be treated as, flow-through entities for US federal income tax purposes in order to avoid a separate layer of taxation.
- Non-US subsidiaries may be formed by a US fund in order to hold investments or conduct activities outside the United States.

2.9 Requirement for Local Investment Managers

There is no requirement under federal or state law that a US fund must have a US investment manager.

2.10 Other Local Requirements

Generally, there are no US legal requirements that mandate local directors, general partners or business premises. However, nearly all US states require that a legal entity formed in a particular jurisdiction should have a registered office and/or a registered agent designated in that jurisdiction.

When an alternative fund is formed under the laws of a US state (eg, Delaware, New York), such fund is subject to applicable state laws and regulations governing its chosen legal form, including concerning formation, governance, rights of equity holders and mergers, consolidations or dissolutions.

2.11 Rules Concerning Other Service Providers

Broad Discretion to Appoint Service Providers

As a general matter, under relevant federal law, alternative funds and their managers have discretion to appoint service providers; however, where a fund has engaged a service provider, the fund and its manager ultimately remain liable for such fund's regulatory compliance.

Custodians — SEC Custody Rule

Under the Advisers Act, where an alternative fund's adviser is deemed to have "custody" of the fund's assets, the adviser becomes subject to the Custody Rule which, among other things, requires the adviser to place the fund's securities with custodians who meet the definition of "qualified custodian". This includes US-regulated banks and brokers, as well as foreign financial institutions that segregate customer assets from the institution's proprietary assets. If the adviser chooses to comply with the Custody Rule by delivering audited annual financial statements of the fund to its investors, the auditor must be registered with and subject to examination by the Public Company Accounting Oversight Board. The SEC has recently proposed modifications to the Custody Rule (proposed as a new "Safeguarding Rule"), which, if adopted as proposed, will extend the custody obligations to currently excluded assets (eg, investments in underlying private funds such as those made by funds of funds) making compliance more operationally challenging.

There are no specific regulatory requirements for non-local service providers.

2.12 Anticipated Changes

See **2.11 Rules Concerning Other Service Providers** regarding changes to the Custody Rule.

In late August 2023, the SEC also adopted changes to rules related to investment managers of private funds (the "PF Adviser Rules") which will impact contractual relationships between private funds and investors (see **4.2 Side Letters**) as well as impose disclosure and reporting obligations, including, but not limited to, detailed quarterly reports to fund investors regarding fund performance, fees and expenses.

In May 2023 the SEC adopted final rule amendments to Form PF that, among other things, will require "large hedge fund advisers" (at least USD1.5 billion in relevant AUM) to file current reports with the SEC no later than 72 hours following certain triggering events (eg, extraordinary investment losses, significant margin/default events, significant redemption events, etc).

See also **2.4 Disclosure/Reporting Requirements.**

3. Fund Managers

3.1 Origin of Promoters/Sponsors of Alternative Funds

US alternative funds are predominantly established by US promoters and sponsors, although managers and sponsors from around the world do also establish US funds for various purposes.

3.2 Legal Structures Used by Managers

Management companies are often formed as LLCs that are wholly owned by holding companies structured as limited partnerships, to address the specific tax and economic considerations impacting the principals of those entities.

Entities receiving performance allocation or carried interest, which are often owned outside of the holding company mentioned above for tax reasons, are typically structured as LLCs.

Certain managers (such as those who utilise quantitative strategies or proprietary intellectual property) may also form separate subsidiaries or affiliated entities to hold intellectual property, employ employees, or engage in estate or financial planning.

3.3 Regulatory Regime for Managers

Investment Advisers Act

Registration requirements

The Advisers Act establishes registration and other obligations for "investment advisers", generally defined as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities". In general, the investment manager of, or investment adviser to, an alternative fund will be presumed to be acting as an investment adviser and will be required to register as such unless an exemption from registration is available. Depending on the amount of "regulatory assets under management" that the adviser is managing and where the adviser has its principal office and place of business (ie, whether inside or outside the United States, and if within the

United States, in which state), the adviser may be required to register at either the state level with one or more state securities regulators, or federally with the SEC.

Exempt reporting adviser status

In lieu of registration with the SEC (but not necessarily with the states), a manager may be able to claim an exemption as an "exempt reporting adviser" in the following circumstances:

- if the manager acts as an adviser solely to "private funds" (meaning funds that are excluded under Section 3(c)(1) or 3(c)(7) of the Investment Company Act) and has "regulatory assets under management" of less than USD150 million; or
- if the manager acts as an investment adviser solely to one or more "venture capital funds", as defined under SEC rules.

Importantly, exempt reporting adviser status is not self-effectuating and must be affirmatively claimed by filing and periodically updating an abbreviated version of the Form ADV. Non-US advisers may also claim these exemptions under somewhat modified conditions. Exempt reporting advisers are only subject to certain limited regulatory requirements (eg, policies designed against misuse of material non-public information, the Advisers Act's "pay to play" rule, general anti-fraud requirements and general record-keeping obligations).

A manager based abroad may qualify as a "foreign private fund adviser", which is not subject to SEC regulation and does not need to file any reports with the SEC, if it:

- has no place of business in the United States;
- has fewer than 15 clients in the United States and US investors in private funds it advises;
- has aggregate assets under management, attributable to such US clients and investors, of less than USD25 million; and
- neither holds itself out to the public in the United States as an investment adviser, nor acts as an investment adviser to any registered investment company or business development company.

If a manager has the requisite amount of assets under management (USD25 million or USD100 million depending on the state in which it is located) or is a foreign adviser and does not qualify for any of the exemptive statuses described above, it will need to be registered with the SEC as an investment adviser. Among other things, a registered investment adviser must do the following:

- A registered investment adviser must file Form ADV with the SEC and amend such filing on an annual basis, within 90 calendar days of fiscal year end, and on an other-than-annual-basis, upon certain developments. Form ADV consists of three parts – Part 1 consists of entering data into a standard information-collection form; Part 2 requires preparation of certain plain-language brochures describing the adviser's business and certain advisory personnel; and Part 3 (which is not required to be filed by advisers who solely advise alternative funds or who otherwise have no natural persons as clients) requires preparation of a client relationship summary (also known as "Form CRS"). Form ADV disclosures include required information regarding certain disciplinary actions to which a firm or its personnel may be subject.
- The adviser must act as a fiduciary with respect to all its clients. Advisers owe duties of loyalty and good faith to clients, and must act in accordance with those duties, including by providing full and fair disclosure of

all material facts to current and prospective investors. Certain disclosures are required to be provided to clients and investors on a periodic basis.
- The adviser must adopt and maintain written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and related regulations and have a code of ethics governing employee behaviour (including personal trading reporting, and restrictions and enforcement of certain insider trading procedures).
- The adviser must maintain certain books and records for specified time periods. These records are subject to inspection by the SEC, including as part of periodic routine inspections of registered firms by the SEC.
- The adviser must comply with certain restrictions and guidelines with respect to advertising and marketing of services and funds, as well as with respect to arrangements with third-party solicitors.
- The adviser must only charge performance-based fees to investors that are "qualified clients", as defined in Rule 205-3 under the Advisers Act.

If a US manager does not have the requisite amount of assets under management, the manager will need to register with, or seek exemptions from, the state(s) in which it operates. State regulatory regimes often have many analogous features to those of the federal regime described above.

Commodity Exchange Act

Registration requirements

Firms managing or advising alternative funds that invest in exchange-traded futures contracts, swaps and/or other "commodity interests" regulated under the CEA (referred to as "commodity pools") are generally required to register as commodity pool operators (CPOs) and/or commodity trading advisers (CTAs) under the CEA (unless an exemption is available) and become members of the NFA. A CPO is defined as "any person engaged in a business which is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests", and a CTA is defined as "any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading" in commodity interests, with some exceptions. If an alternative fund is a commodity pool, it will have at least one CPO (whether registered or exempt), but a commodity pool may have multiple CPOs and/or one or more CTAs providing it with commodity interest trading advice, depending on the fund's structure. Where the degree of commodity interest trading by an alternative fund is sufficiently limited, its managers and advisers may be able to claim exemption from registering as CPOs and/or CTAs.

Registered CPOs and CTAs

Registered CPOs and CTAs are subject to CFTC rules and requirements mandating:

- specified disclosures to pool investors and clients, including, but not limited to:
  - (a) specified regulatory legends;
  - (b) information about the CPO or CTA, its trading strategy, principals and service providers;
  - (c) principal risk factors and conflicts of interest;

(d) associated fees and expenses; and
(e) disclosure of certain litigation matters and detailed prior performance information;
- periodic reporting both to pool investors and to the CFTC and NFA; and
- specific record-keeping practices.

In addition, as NFA members, most registered CPOs and CTAs are also subject to compliance with NFA rules, which set out a number of compliance obligations related to supervision, approval and use of promotional material; collection of customer information and provision of customer risk disclosures; calculation and presentation of performance information; and the creation and maintenance of a written business continuity and disaster recovery plan, and written information systems security programme and internal controls systems, among others.

Rule 4.7 exemptive relief

A registered CPO may claim exemptive relief under CFTC Rule 4.7 in respect of one or more commodity pools, which exempts the CPO from certain of the more prescriptive disclosure, record-keeping and reporting requirements under CFTC rules (as well as certain marketing limitations under NFA rules), if the applicable pool is only offered and sold to investors who are "qualified eligible persons", as defined in Rule 4.7.

Securities Exchange Act

Broker-dealer registration

In general, entities that engage in the business of effecting securities transactions for US persons are required to be registered with the SEC as broker-dealers under the Exchange Act. However, the SEC has indicated that an investment adviser, such as the manager of an alternative fund, need not register as a broker-dealer as long as the adviser:

- does not receive transaction-based compensation;
- does not hold client funds or securities; and
- executes client transactions through a registered broker-dealer.

Section 13 public reporting

Managers may be subject to Section 13 public reporting requirements if they:

- beneficially own more than 5% of a class of voting equities in certain public companies (Schedule 13D or 13G);
- manage discretionary accounts that hold, on aggregate, USD100 million or more in any of a specified list of US exchange-traded securities (Form 13F); and
- manage discretionary accounts that trade, in the aggregate, an amount of covered securities exceeding specified volume or value thresholds (Form 13H).

3.4 Tax Regime for Managers

US Manager

Fund managers to US alternative funds are generally formed as limited partnerships or LLCs and are "flow-through entities" from a US tax perspective. As such, these entities are not subject to tax at the entity level, but are subject to the special carried interest rules discussed under **3.6 Taxation of Carried Interest**.

Non-US Manager

Whether a non-US manager will be subject to US federal income tax will depend on whether (based on the applicable facts and circumstances) the manager is doing business in the United States. If the manager is performing its investment management services from an office located outside the United States, then the manager should not be subject to US federal income tax (assuming it has no other business activity in the United States). Hiring US employees will generally cause a non-US manager to be considered as doing business in the United States, as will leasing office space in the United States. State and local tax consequences (which may vary depending on the tax laws of the applicable state) also need to be considered. A non-US fund manager which expects to have a physical presence in the United States may be advised to form a US subsidiary taxable as a corporation to conduct the US-based activity so that the parent company does not have any direct nexus with the United States.

3.5 Rules Concerning Permanent Establishments

The activities of a fund general partner or investment manager are normally attributed to the fund, for US federal income tax purposes, unless the investment manager qualifies as an "independent" agent. Qualifying as an independent agent may be difficult for investment managers that have not sponsored multiple funds (and do not perform investment management services for other clients).

Safe Harbours

However, if the activities of the fund consist of investing in or trading securities, commodities (as defined) or notional principal contracts for the fund's own account (and do not involve loan origination or investing in flow-through entities conducting a business, such as master limited partnerships), then the presence of a US general partner or investment manager generally should not cause a non-US fund or investor to be subject to US federal income tax on the income and gain generated by the activity. Safe harbours are provided for such activities, under which they do not give rise to income or gain that is treated as effectively connected with a US trade or business, as long as the fund is not a "dealer" (whether inside or outside the United States) in such instruments. Hedge funds and commodity funds typically structure their investments and activities with a view to qualifying under one or more of these safe harbours.

Activities That Fall Outside Safe Harbours

A fund that is acting as a "specialist" or "market maker" in securities will need to analyse whether such activities would cause it to be treated as a "dealer" for US federal income tax purposes, such that it will be unable to rely on the foregoing safe harbours with respect to its securities trading. Acting as a dealer will cause the fund to generate effectively connected income for its non-US investors, if its dealer activity is being conducted in the United States, and unrelated business taxable income for its US tax-exempt investors.

Certain US activities, such as loan origination, acting as a dealer in securities or commodities, and investing in real estate and certain so-called "US real property holding corporations", fall outside the foregoing safe harbours and can be expected to generate US trade or business income, including so-called "FIRPTA gain" (from the Foreign Investment in Real Property Tax Act of 1980 in the case of US real property investments) for non-US investors. As such, these types of investments are likely to raise US tax issues for non-US investors and may require complex structuring in order to mitigate the adverse US federal income tax consequences for such investors.

Taxation of Carried Interest

The character (as ordinary income, short-term capital gain or long-term capital gain) of amounts allocated to the manager as its carried interest is the same as it was when recognised by the relevant fund. In addition, US self-employment tax considerations may make the use of a limited partnership as the structure of the entity receiving management fees more attractive than using an LLC. If the US manager is formed as a limited partnership, a separate entity is generally formed to act as the general partner of such limited partnership. US fund managers often utilise two entities: one to receive the management fee, and the other to receive the carry. This has several benefits for US managers, including providing flexibility as to who participates in the economics of each entity.

3.6 Taxation of Carried Interest

Carried interests (commonly described as incentive allocations with respect to hedge funds) are not taxable upon receipt, and carried interest allocations are not taxed as compensation even though the carried interest is issued for services. Instead, the character (as ordinary income, short-term capital gain or long-term capital gain) of amounts allocated with respect to carried interest is the same as it was when recognised by the partnership, except that long-term capital gain recognised by a partnership on the sale of an asset held for not more than three years is treated as short-term capital gain (which is not eligible for federal income taxation at reduced rates) when allocated to a non-corporate holder of carried interest. Also, capital gain recognised by a carried-interest holder on the sale of its carried interest is treated as short-term capital gain, rather than long-term capital gain, if the carried interest was not held for more than three years prior to being sold.

3.7 Outsourcing of Investment Functions/Business Operations

Managers are permitted to outsource a substantial portion of their investment functions or business operations. Firms that provide those services must be appropriately registered, or exempt from registration, with the relevant US authorities.

Managers remain responsible for ensuring effective compliance with their regulatory obligations, even with respect to outsourced services.

See **3.10 Anticipated Changes**.

3.8 Local Substance Requirements

See **2.10 Other Local Requirements**.

Registered investment advisers, CPOs and CTAs managing alternative funds are not subject to any regulatory capital requirements or other local substance requirements under applicable federal law and related SEC, CFTC and/or NFA rules (as applicable).

3.9 Change of Control

Under Section 205(a)(2) of the Advisers Act, an investment adviser may not enter into an investment advisory contract unless that contract provides that no “assignment” of such contract may be made without the applicable client’s consent. Under the Advisers Act and rules thereunder, “assignment” generally refers to any direct or indirect transfer of a contract, or a change in control of the investment adviser. Accordingly, a merger, sale, restructuring or similar transaction involving a fund manager or its parent company, depending on the structure of the transaction, may require the consent of clients under applicable investment advisory contracts. The means of obtaining consent will vary based upon the structure of the client relationship (eg, fund, managed account, etc).

3.10 Anticipated Changes

See **2.12 Anticipated Changes**.

Executive Pay Proxy Voting Reporting

Managers that file Form 13F (See **3.3 Regulatory Regime for Managers**) will need to disclose annually on SEC Form N-PX their proxy voting records pertaining to certain executive compensation matters. The first filing is due 31 August 2024 for the reporting period 1 July 2023 to 30 June 2024.

Outsourcing by Investment Advisers

The SEC, in late 2022, proposed rules to require SEC-registered advisers to satisfy specific due diligence elements before retaining a service provider to perform certain services or functions that are necessary for an adviser to provide advisory services in compliance with the federal securities laws and which, if not performed or performed negligently, would result in a material negative impact on clients.

Predictive Data Analytics

The SEC, in July 2023, proposed new rules that would require SEC-registered investment advisers to, among other things, eliminate/neutralise conflicts of interest that result in placing the firm's interests ahead of investors' interests, when using "covered technology" (eg, algorithms, artificial intelligence, etc) in "investor interactions" (including prospective and current investors in private funds).

4. Investors

4.1 Types of Investors in Alternative Funds

US taxable investors are keen to invest in US alternative funds, although investors in US funds increasingly include those from other jurisdictions. These investors include:

- high net worth individuals;
- family offices;
- funds of funds;
- corporations, partnerships, trusts, insurance companies and other entity investors;
- foundations, endowments and charitable institutions;
- benefit plan and retirement plan investors; and also, from outside the US,
- sovereigns and sovereign wealth funds.

4.2 Side Letters

Under the proposed PF Adviser Rules, all private fund advisers (whether registered or exempt reporting advisers) would generally be prohibited from providing certain preferential terms to investors regarding redemption rights and portfolio transparency preferences, where the adviser reasonably expects such preference could have a material negative effect on other investors in the private fund. Other types of preferential terms would be permitted only with disclosure to all other current investors, or to prospective investors (where the preference relates to "material economic terms"). See **2.12 Anticipated Changes**.

4.3 Marketing of Alternative Funds to Investors

See **2.3 Regulatory Regime for Funds** and **3.3 Regulatory Regime for Managers** for descriptions of the applicable investor qualification standards under the Securities Act, Investment Company Act, Advisers Act and CEA.

4.4 Rules Concerning Marketing of Alternative Funds

No General Advertising or Solicitation

As highlighted in **2.3 Regulatory Regime for Funds** and **3.3 Regulatory Regime for Managers**, alternative funds typically offer their interests to US investors in Rule 506(b) offerings and thus may not engage in general solicitation or general advertising in connection with the offering. Regulation D defines general advertising or solicitation to include:

- any advertisement, article, notice or other communication published in any newspaper, magazine or similar media, or broadcast over television or radio; and
- any seminar or meeting whose attendees have been invited by any general solicitation or advertising.

As noted in **2.3 Regulatory Regime for Funds**, Rule 506 of Regulation D also contains a safe harbour provision, Rule 506(c), which allows for general advertising and general solicitation, but this has not been widely used by alternative funds.

No "bad actors"

Note that in order to rely on either of the Rule 506 safe harbour provisions discussed above, an offering cannot involve the participation of certain "bad actors" in the roles specified under the Rule. In particular, persons covered under Rule 506 (including the fund, its manager, its directors and executive officers, beneficial owners of 20% or more of the fund's voting interests and other promoters, placement agents or solicitors acting on behalf of the fund) cannot be subject to any of an enumerated list of disqualifying events, such as criminal convictions, court injunctions and restraining orders, and certain regulatory or disciplinary orders.

SEC Marketing Rule

The SEC's Marketing Rule (adopted in late 2020, with a compliance date that began in November 2022) applies to a SEC-registered adviser's traditional advertising and solicitation activities. The Marketing Rule applies to an SEC-registered investment adviser's "advertisements" (including advertisements to prospective clients or investors in private funds) and includes a number of general prohibitions designed to address false and/or misleading statements, as well as specific provisions regarding the use of testimonials/endorsements (including what was previously addressed by the cash solicitation rule); third-party ratings; and performance advertising.

Marketing to US State and Local Government Entity Investors

If a fund manager, or its personnel, market to or solicit investments from, certain US state or local government entities (including employee pension funds), the manager and/or its personnel may be subject to registration and regulation as a "lobbyist" in that jurisdiction. If a manager intends to market to such government entities, it must familiarise itself with the relevant lobbying regulations and filing requirements in the applicable jurisdictions and comply with, or ensure exemption from, those provisions.

In addition, some government entities have adopted restrictive policies with respect to fund managers' use of, and compensation paid to, placement agents or third-party solicitors.

CPO Associated Person Registration

Where personnel of a registered CPO solicit commodity pool investors, those personnel – as well as any persons in the supervisory chain overseeing them – must generally be individually registered with the CFTC and NFA as "associated persons" of the CPO, subject to certain exceptions. In most cases, associated persons must pass the Series 3 examination administered by the Financial Industry Regulatory Authority and, if the CPO is engaged in swaps business, meet the swaps proficiency requirements administered by the NFA.

4.5 Compensation and Placement Agents

Placement Agents and Solicitation Arrangements

Broker-dealer registration generally required

Many alternative funds will utilise third-party placement agents or "finders" to solicit potential investors. These parties are usually required to be appropriately registered or qualified as broker dealers at federal and/or state level. Fund managers should be wary of engaging unregistered parties to provide "finding" services, as these services may involve solicitation and marketing activities that require such persons to be registered broker-dealers, and sales of fund interests by persons who are (improperly) unregistered may be subject to rescission rights under the Exchange Act.

Solicitation under the marketing rule

Under the recently adopted Marketing Rule, SEC-registered investment advisers must comply with certain disclosure and documentation requirements when disseminating "testimonials" or "endorsements" – which typically include the use of third-party solicitors to introduce clients (including investors in private funds) to the firm.

4.6 Tax Regime for Investors

Different federal income tax rules and tax rates apply depending on the tax status of the investor.

US Tax-Exempt Investors

US tax-exempt investors, such as charitable organisations, pension funds, private foundations and individual retirement accounts, among others, are generally exempt from federal income taxation except to the extent that they earn unrelated business taxable income, as defined (UBTI), which most commonly arises when an alternative fund (ie, a flow-through entity for US federal income tax purposes) obtains third-party financing to fund its investments. Acting as a dealer or investing in flow-through entities conducting a business can be expected to generate UBTI for a domestic fund's US tax-exempt investors.

US Non-corporate Investors

A typical US non-corporate investor is subject to regular federal income tax at a rate of 37% plus an additional 3.8% tax applicable to the investor's net investment income. Reduced federal income tax rates apply to such an investor's long-term capital gain, qualified dividends and certain qualifying business income. Various limitations apply to such an investor's ability to deduct certain losses and expenses, including capital losses, state and local income taxes, investment interest expense and other investment expenses.

US Corporate Investors

A typical US corporate investor is subject to regular federal income tax at a rate of 21%. While such an investor does not obtain beneficial treatment of long-term capital gain, it is not subject to many of the limitations on the deduction of losses and expenses by non-corporate taxpayers. Certain small business corporations, known as subchapter S corporations, are generally not subject to corporate income tax and, because their taxable income generally passes through and is taxable to their shareholders, they are generally subject to the rules applicable to non-corporate investors.

Non-US Investors

Withholding tax

US withholding taxes of 30% (subject to reduction under an applicable income tax treaty) generally apply to certain types of non-business income (typically, US source dividends and certain dividend equivalent income, and limited types of US source interest income – commonly referred to as Fixed, Determinable, Annual, or Periodical (FDAP) income) allocable by a US fund to non-US investors. US withholding tax applies to the gross amount of FDAP, without reduction for expenses. Foreign governments and sovereign wealth funds are not subject to US withholding tax on certain types of US source income, including dividends and interest. Capital gain is not generally subject to US income or withholding tax unless it is attributable to investments in US real estate or US real property interests, as defined.

Income tax

Non-US investors are subject to regular US federal income tax on income and gains that are effectively connected with a US trade or business (Effectively Connected Income or ECI), and are subject to US withholding tax on their FDAP. For example, loan origination by a fund (other than a business development corporation) may be treated as generating ECI. Domestic funds with non-US investors are required to make quarterly tax payments to the IRS on account of ECI allocable to non-US investors, and must withhold US tax from redemption payments to the extent attributable to ECI-generating investments. Loan origination and other activities that generate ECI may be tabled by the state in which the fund is making loans or operating, depending on applicable state law.

Preferential Tax Treatment of Certain Entities

US tax laws include provisions allowing preferential tax treatment of certain specialised corporate investment vehicles, such as regulated investment companies and real estate investment trusts. In order to obtain the applicable preferential tax treatment, these entities must, on an ongoing basis, satisfy and comply with various requirements relating to their organisation, share ownership, assets and operations. These requirements make them much less flexible and significantly more expensive to administer than customary investment vehicles such as "regular" partnerships and LLCs, but they are useful alternative fund vehicles for "retail" investors.

4.7 Double Tax Treaties

Utilisation by Investors

US funds (that are taxed as partnerships for federal income tax purposes) generally do not themselves qualify for benefits under double tax treaties with the United States. However, their flow-through status may allow non-US investors to claim tax treaty benefits (typically, a reduction in or complete exemption from 30% US withholding tax) under an income tax treaty between their jurisdiction of residence and the United States. In order to establish eligibility to claim tax treaty benefits, a non-US investor will typically be asked to provide an applicable IRS Form W-8.

Structuring Issues

Certain jurisdictions, such as Canada and the UK, may limit the availability of tax treaty benefits to a resident of those jurisdictions who or which invests in a fund organised as an LLC rather than as a limited partnership. For this reason, US funds that are targeting non-US investors will commonly be organised as limited partnerships rather than as LLCs.

4.8 Foreign Account Tax Compliance Act (FATCA)/Common Reporting Standard (CRS) Compliance Regime

Under FATCA, US funds are generally required to collect a 30% US withholding tax on their payments of US source dividends and interest to a non-US "foreign financial institution" or "non-financial foreign entity" (each as defined) unless such non-US person makes certain certifications or provides certain information relating to its US owners or qualifies for exemption from FATCA. Typically, a US fund will obtain the appropriate IRS Form W-8 from such investors that will include the requisite FATCA certifications. Different rules may apply to foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing FATCA.

US funds are not subject to the Common Reporting Standard (CRS) compliance regime.

4.9 Anti-Money Laundering (AML) and Know Your Customer (KYC) Regime

During regulatory examinations, the SEC staff routinely request information from investment advisers to alternative funds regarding AML compliance policies and procedures. Information requested frequently includes the identity of private fund investors.

4.10 Data Security and Privacy for Investors

Pursuant to the Gramm-Leach-Bliley Act ("GLBA"), Regulation P requires funds to provide notices to their investors regarding the funds' privacy policies to protect investor non-public personal information ("NPI") and to enable the funds' investors to opt out of disclosure of their NPI to most non-affiliated third parties. In addition, pursuant to the GLBA, Part 314 of the Federal Trade Commission rules requires funds to maintain comprehensive information security programs that are reasonably designed to safeguard the NPI of fund investors. Part 314 requires funds to maintain a wide array of specific data security controls.

4.11 Anticipated Changes

See **4.2 Side Letters**.

The SEC has proposed cybersecurity risk management rules that, if adopted, will require managers that are federally registered as investment advisers to enhance their cybersecurity risk disclosures, adopt written policies and procedures that address cybersecurity risks, and report significant cybersecurity incidents to the SEC on proposed Form ADV-C.

CHAMBERS GLOBAL PRACTICE GUIDES

Chambers Global Practice Guides bring you up-to-date, expert legal commentary on the main practice areas from around the globe. Focusing on the practical legal issues affecting businesses, the guides enable readers to compare legislation and procedure and read trend forecasts from legal experts from across key jurisdictions.

To find out more information about how we select contributors, email Katie.Burrington@chambers.com